



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**To: Robynn Wilson, Chair**  
**Members of MTC Income & Franchise Tax Uniformity Subcommittee**  
**From: Shirley Sicilian, General Counsel**  
**Date: January 31, 2011**  
**Subject: Model Compact Art. IV.17 Amendments**

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The Subcommittee has been working through the drafting group's<sup>1</sup> list of three remaining policy questions for revisions to the Compact Art.IV.17. (see Attachment A). During its teleconference on October 19, 2010, the Subcommittee answered the first two of these three policy questions, and asked the drafting group to:

1. Include explicit regulatory authority, and
2. Include an explicit requirement that taxpayer reasonably approximate the market if sourcing cannot otherwise be specifically determined under the rule.

During its December 7, 2010 in-person meeting, the Subcommittee began to address the third remaining policy question: how to source receipts from sales and licensing of intangibles. This question is divided into two parts. The first part, 3.A., covers receipts from intangibles that were held as taxpayer's product for sale or license to its customers.<sup>2</sup> The second part, 3.B., covers receipts from sale or license of intangibles that are or were used by the taxpayer as an asset in its unitary business.<sup>3</sup> In December, the Subcommittee focused on the first part, 3.A, and directed drafting group to:

1. Separately source receipts from transactions involving intangible products depending on whether the transaction was a license or a sale.
2. For receipts from the *license* of intangible products, source to the location where the intangible is "used." If the intangible is used in whole or part for "marketing," the location of use should be the location of the consumer. (That is, follow the Massachusetts approach).
3. For receipts from the *sale* of intangible products, identify reasonable sourcing options for further Subcommittee consideration.

The attached draft reflects Subcommittee direction on questions 1 through 3.A. (see Attachment B). Note that under §17(a)(5) the drafting group is suggesting that sales

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<sup>1</sup> Drafting group includes Ben Miller, Melissa Potter (CA-FTB); Joe Garrett (AL); Michael Fatale (MA); Debra Buchanan, Gary Humphrey (OR); Ted Spangler; and Staff, Bruce Fort and Shirley Sicilian.

<sup>2</sup> These would include receipts from intangible transactions occurring in the ordinary course of the taxpayer's regular trade or business – e.g., license of trademarks, or sale or license of patents or copyrights.

<sup>3</sup> These would include receipts from non-inventory assets that are or were used in the operation of taxpayer's unitary business – such as good will, working capital, treasury function related investment assets, or sale of patents/copyrights that had previously been used by the taxpayer to manufacture its own product for sale to its customers.

of only certain types of intangibles – those for which the market is likely to be known by the taxpayer – should be specifically sourced. These are sales of a contract right, government license<sup>4</sup>, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area. Other sales are explicitly removed from sourcing, because even though a taxpayer may be able to apply the sourcing rule at the time of the sale, it may be impossible for the tax department to verify later that it had been applied appropriately. This approach would follow that currently being proposed in Massachusetts.

The last questions, under part 3.B. of the remaining policy question list, involves how to source receipts from sales, lease or license of intangibles used as assets in the taxpayer's business. But a threshold question to be answered before working on a sourcing rule for these types of receipts is whether they should be included in gross receipts for sales factor purposes at all. That threshold question requires us to turn attention to another Compact provision which the Executive Committee identified as needing amendment – Article IV.1(g), the definition of “sales.” The drafting group has developed a policy question list for that Compact provision (see Attachment C).

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<sup>4</sup> “Government license” does not refer to patents or copyrights, but rather to franchises or rights of way granted by the government.



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**Model Compact Art. IV.17 Amendments  
Income & Franchise Tax Uniformity Subcommittee**

**Remaining Policy Questions  
For Discussion Purposes Only**  
**► Showing Subcommittee Answers**

*January 31, 2011*

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- 1. Explicit Regulatory Authority.** Should an explicit reference to regulatory authority be added to Section 17? For example:

17(c) The tax administrator may proscribe regulations as necessary or appropriate to carry out the purposes of this section.”

**► Subcommittee: yes, include reference in statute.**

- 2. “Reasonable Approximation”.** With the removal of the “cascade” language, is it necessary that the statute explicitly authorize “reasonable approximation” directly in the sourcing provision (a)?

- A.** Would “reasonable approximations” be better as part of the “contingency” provisions under 17(b)? For example:

17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer’s market for the sale is in this state. The taxpayer’s market for a sale is in this state...

(3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; ~~provided, that if such location cannot be determined, it shall be reasonably approximated;~~

(4) In the case of sale, lease or license of intangible property, if and to the extent the intangible property is used by the payor in this state; ~~provided, that if the location of such use cannot be determined, it shall be reasonably approximated.~~

(b) If the taxpayer is not taxable in a state to which a sale is assigned, or if the state of assignment under subsection (a) can not be determined ~~under subsection (a) or reasonably approximated~~, such sale shall be excluded from the denominator of the sales factor.

- B. Or, could “reasonable approximations” be allowed, and better addressed, through regulation?

► *Subcommittee: Should include reasonable approximation in statute.*

3. **Sale or License of Intangible Property.** When the taxpayer sells or licenses intangible products, how should it source the receipts from that sale or license? In **section 3.A**, we consider sourcing for receipts from intangibles that are sold or licensed by the taxpayer as a product which the taxpayer provides to its customers. In **section 3.B**, we consider receipts from non-inventory, business assets – such as good will, working capital, or treasury function related investment assets – that are or were used in Taxpayer’s own unitary business.

**A. Receipts from intangible property that was held as inventory for sale or license to taxpayer’s customers.** These would include receipts from intangibles transactions occurring in the course of the taxpayer’s regular trade or business, including receipts from intangibles that had been held as inventory for sale or license to customers – such as, logo’s, cartoon characters, or patents/copyrights that are held for sale/license in the ordinary course of business to taxpayer’s customers.

- i. **Sourcing options.** Where is the “market” for the sale or licensing of intangible property?

- a. Where delivered? (Same rule as used for tangible property in current model and for services in draft model.)
- b. Taxpayer’s commercial domicile?
- c. Customer’s commercial domicile?
- d. Customer’s billing address?
- e. Customer’s office from which product was ordered?
- f. As provided by contract?
- g. Customer’s activities?
  - (1) Customer’s use of the intangible in state? (E.g., customer’s production of a patented product in the state. Or customer’s use at the time of purchase? And, if used in more than one state, a ratio of the customer’s location of use at the time of purchase in this state compared to the customer’s location of use at the time of purchase everywhere?)
  - (2) Customer’s sales to customer’s customers in state? (Or customer’s sale of a product to customer’s customers that results in fees for the taxpayer.)
- h. Population (relative to other states in the area where the taxpayer’s customer is permitted to use the intangible)?

- ii. **Use multiple sourcing options?**

- a. **Differentiate between different types of transactions?** *See, e.g., CA draft in appendix*

- (1) **Complete transfer** (Sale)
  - (2) **Anything less than a complete transfer** (Licensing, leasing, rental or other permission to use of intangible property, including franchises, patents, copyrights, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, technical know-how, and contracts pursuant to a licensing, leasing, rental, or similar agreement, etc.)
- b. **Differentiate between different types of intangibles?** *See, e.g., MA rule (partially superseded) in appendix.*
- (1) **Commercial and Trade intangibles** (e.g., commercial intangibles may include patents, know-how, designs and models used in production of goods or provision of services, and computer software; and trade intangibles may include research and development activities. OECD)
  - (2) **Marketing intangibles** (e.g., marketing intangibles include trademarks and trade names used to commercially exploit a product or service, customer lists, distribution channels, and unique names, symbols, or pictures with important promotional value. OECD)
  - (3) **“Mixed” intangibles.**
- c. **Differentiate between different types of customers?**
- (1) **Individual persons, main street business vs. multistate businesses?**  
Customers that are individual persons or “main street businesses” are likely to be more easily located in a single state because all relevant activities are more likely to be in that single state. But when the customer is a multistate business with activities in more than one state, then do we need to more specifically identify which activity(s) will determine the state to which we’ll source?
  - (2) **Related entity customers vs. unrelated entity customers?** If the general rule is conceptually good for most situations, but might allow for manipulation, should we consider a special rule for situations where taxpayer and customer are related entities?
- d. **“Cascades?”** Should alternative rules be provided in the statute for those situations where information needed to source based on the primary rule(s) is not “readily determinable?” Or should “reasonable approximations” of the primary rule be allowed in statute and/or identified in regulations? *See, e.g., CA draft rule, MA rule (partially superseded), both in appendix.*

► Subcommittee: Differentiate between license and sale of intangible. Further differentiate between license of “marketing” intangible and licence of other types of intangibles, treating “mixed” intangibles as “marketing” intangibles. Source licensing of intangibles to place of “use” where “use” of marketing intangibles is location of consumer.

**B. Receipts from sale or license of intangible property that is or was used as a business asset in TP’s unitary business.** These would include receipts from

non-inventory, business assets that are or were used in Taxpayer's unitary business – such as good will, working capital, treasury function related investment assets, or patents/copyrights that had previously been used by the taxpayer to manufacture its own product for sale to its customers.

- i. Included in gross receipts?** *See* policy checklist for definition of “sales.” Should the sales factor include gross receipts from transactions involving taxpayer's intangible property that is not inventory, but is (or was) instead used in the unitary business? Should the answer to this question be the same as for gross receipts from transactions involving taxpayer's other (real and TPP), business assets?
- ii. Sourcing options** (if included in gross receipts):
  - a.** The same as receipts from intangible products sold or leased (marketed) to “customers” are sourced?
  - b.** The same as receipts from sale of real or tangible assets used in the business would be sourced?
  - c.** Buyer's commercial domicile?
  - d.** Taxpayer's commercial domicile? *See, e.g.,* UDITPA or MA rule (partially superseded), both in appendix.



MULTISTATE TAX COMMISSION

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**Model Compact Art. IV.17 Amendments**  
**Draft – for Discussion Purposes Only**  
*Sources Gross Receipts - Narrowly Defined*

***1-31-2011***

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17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:

- (1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
- (2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
- (3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; ~~provided, that if such location cannot be determined, it shall be reasonably approximated;~~
- (4) In the case of ~~sale~~, lease or license of intangible property; or sale or other exchange of such property if the receipts from such sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property; if and to the extent the intangible property is used by the payor in this state, provided that ~~if the location of such use cannot be determined, it shall be reasonably approximated~~ intangible property used in marketing a good or service to a consumer is used in this state if the good or service that is marketed using the intangible property is purchased by a consumer who is in this state; and
- (5) In the case of sale of intangible property other than that referenced in section (4), above; where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area; if and to the extent the intangible property is used in or otherwise associated with this state, provided that any sale of intangible property not otherwise described in this section (5) or section (4) above shall be excluded from the numerator and the denominator of the sales factor.

- (b) If the state of assignment cannot be determined under subsection (a), it shall be reasonably approximated.
- (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (~~a~~b), such sale shall be excluded from the denominator of the sales factor.
- (~~e~~d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]





**MULTISTATE TAX COMMISSION**

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**Income & Franchise Tax Uniformity Subcommittee  
Model Compact Art. IV.1(g) Amendments – Definition of “Sales”**

**Policy Question List  
October 8, 2010**

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- I. Should “sales” continue to be broadly defined as “all gross receipts,” or more narrowly defined to reflect the taxpayer’s market by including only receipts from taxpayer’s sales of its product to its customers? Is it appropriate to include a receipt from the sale of a production asset in the sales factor when the value of that asset is already included in the property factor? Is it necessary to include such a receipt when the income from the sale reflects value that accrued and depreciation expense which was taken against income generally over a long period of time? Should the sales factor include all items of business income?
- A. Rationale for Narrow approach: The role of the sales factor in the apportionment formula is to reflect the contribution of the market, or the demand side, to the earning of income. The property and payroll factors represent, respectively, the contribution of capital and labor or, collectively, the supply side. The factors themselves are not what is being taxed, they only reflect activities that give rise to income. As such, the items included in any factor should only reflect the activities it is designed to represent. It is therefore unnecessary, and in fact may be counter-productive, to include an item in the factor if it does not reflect that activity. In the case of the sales factor, only those items that represent the market, sales to customers, should be included. Because the sales factor is intended to balance the property and payroll factors it should be defined to offset rather than amplify the effects of the property and payroll factors. But including receipts from the sale of assets used in the business Because the purpose of the sales factor is to balance the other two factors, the use of those two elements to assign sales, costs of production, should be avoided. (*See*, Appendix – example of statute using narrow approach)
- B. Rationale for Broad approach: Reflects current model. Responsive to claim that: If a net receipt is included in the pool of income to be apportioned, the corresponding gross receipt should be included in the sales factor used to apportion it. Also, omitting receipts from a large asset sale could result in distortion to the extent the state does not include a property factor in its apportionment formula. For example, if taxpayer made a large gain on the sale of production assets located in a single sales factor state where it had made relatively few sales, and if that gain made up a significant part of the taxpayer’s apportionable income, then the State’s single sales factor apportionment formula may

produce a mismatch between where the apportionable income arose and where it's being apportioned. Including these types of receipts in the sales factor, and sourcing them to the location of the asset that produced the receipt, could alleviate this mismatch. Even states that do have a property factor could experience distortion if the sale took place early in the year (so that the property that produced the gain is not fully included in the property factor). If these situations occur and create distortion on a regular basis, then *ad hoc* relief under section 18 may not be the most efficient remedy. (See, Appendix – example of statute using broad approach)

II. If sales continue to be broadly defined, should the statute be amended to exclude certain receipts that generally create distortion, or do current model regulations adequately excluded these types of receipts?

- A. repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
- B. the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
- C. proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
- D. damages and other amounts received as the result of litigation;
- E. property acquired by an agent on behalf of another;
- F. tax refunds and other tax benefit recoveries;
- G. pension reversions;
- H. contributions to capital (except for sales of securities by securities dealers);
- I. income from forgiveness of indebtedness;
- J. amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code
- K. receipts related to transactions involving liquid assets held in connection with one or more treasury functions of the taxpayer;
- L. receipts from hedging transactions involving intangible assets, including options contracts to hedge foreign currency.

III. Implication for Section 17 statutes and regulations

- A. If we choose a narrow approach, there is no need for numerator sourcing of receipts from sale of intangible assets used in the unitary business.
- B. If we choose a broad approach, we need to consider numerator sourcing for receipts from sale of intangible assets used in the unitary business. E.g.:
  - 1. Location of the related tangible asset?
  - 2. Taxpayer's commercial domicile?
  - 3. Customer's commercial domicile?
  - 4. Different rules for some or all types of intangible asset sales? (e.g., receipts from sale of goodwill sourced to location of business's tangible assets; receipts from treasury function transactions sourced to location where function performed; etc.)

IV. Should the statute specify that sales are eliminated in the context of combined reporting, or is this something that, if it should be done, should be done either in the combined reporting statutes or by regulation?

**- Appendix to Attachment C -**  
**Definition of Sales – Examples Illustrating Narrow and Broad Approaches**  
***Illustrations For Discussion Purposes Only***

• **Narrow Approach - Example**

- 1(g) “Sales” means total amounts received from a customer for:
- (A) goods, products or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period,
  - (B) provision of services, or
  - (C) rental, lease or licensing of property.

Accompanying regulation, or continuation of statute:

For purposes of this definition, “total amounts received” means the sum of money and fair market value of other property or services received by the taxpayer from transactions and activity in the regular course of its trade or business, net of returns and allowances, and includes interest, service charges, carrying charges, time-price differentials, and excise taxes if such taxes are passed on to the customer or included as part of the selling price.

[OPTIONAL] For purposes of this definition, “customer” does not include an entity whose unitary income is included with the taxpayer’s unitary income in the calculation of the total unitary income subject to apportionment.

• **Broad Approach - Example**

- 1(g) “Sales” means the total amount of receipts arising from transactions or activities that produce unitary income, but does not include:
- 1) repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
  - 2) the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
  - 3) proceeds from issuance of the taxpayer’s own stock or sale of treasury stock;
  - 4) damages and other amounts received as the result of litigation;
  - 5) property acquired by an agent on behalf of another;
  - 6) tax refunds and other tax benefit recoveries;
  - 7) pension reversions;
  - 8) contributions to capital (except for sales of securities by securities dealers);
  - 9) income from forgiveness of indebtedness;
  - 10) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code
  - 11) receipts related to transactions involving liquid assets held in connection with one or more treasury functions of the taxpayer; and
  - 12) receipts from hedging transactions involving intangible assets, including options contracts to hedge foreign currency.